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Study on the Contribution of Tax System in the Economic Growth of the Nation

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Abstract*: This article examines the long-term effects of modifications to the personal income tax on economic growth. The structure and financing of a tax reform are essential for attaining economic growth. Reducing tax rates can incentivize individuals to engage in work, saving, and investment. However, if these tax cuts are not accompanied by significant reductions in government spending, they are likely to result in a larger federal budget deficit. This, in turn, will decrease national saving and lead to higher interest rates in the long term. Considerable analysis suggests that the impact on growth is either insignificant or adverse. Implementing base-broadening policies can mitigate the impact of tax rate reductions on budget deficits. However, these policies also reduce the effects on labor supply, savings, and investment, so diminishing the direct influence on economic growth. However, they also redistribute resources throughout sectors to optimize their utilization based on their highest economic worth, leading to increased efficiency and potentially a larger total economy. Findings suggest that different tax policies can have varying impacts on economic development. Reforms that enhance incentives, abolish current subsidies, reduce unexpected profits, and refrain from using deficit financing will have more advantageous long-term impacts on the size of the economy. However, these reforms may also create choices between fairness and effectiveness*

Keywords: economic growth, taxation, policy changes, financial plan, system

I. INTRODUCTION

Policymakers and economists have consistently shown interest in assessing the effects of potential modifications to the personal income tax system on the overall magnitude of the economy. Earlier this year, Representative Dave Camp (R-MI) put forward a significant proposal to restructure the income tax system. The proposal aims to lower tax rates, significantly cut subsidies in the tax code, and maintain revenue and distributional neutrality, as stated by the Committee on Ways and Means in 2014.

This article analyzes the influence of tax modifications on the rate of economic expansion. Our focus is on two types of tax changes: reductions in individual income tax rates and "income tax reform." This expansion may entail an augmentation in the annual growth rate, a singular surge in the magnitude of the economy that does not impact future growth rates but positions the economy on an elevated growth trajectory, or a combination of both. Our focus on the production side of the economy and the long-term perspective differs from the short-term occurrences, sometimes referred to as "economic growth," where a rise in overall demand in a slow-moving economy can boost GDP and allow real GDP to match potential GDP.

The importance of the concerns mentioned arises from the income tax's crucial function in gathering revenue, its impact on the distribution of income after taxes, and its effects on a broad spectrum of economic activity. The gravity of the issue is further amplified by the recent underwhelming economic performance, apprehensions over the long-term economic growth rate, and concerns about the federal government's fiscal health in the long run.

Although it is widely acknowledged that tax policy can influence economic decisions, it is not immediately clear if reducing tax rates will inevitably lead to a larger economy. Lowering the tax rates would boost the post-tax profits from working, saving, and investing. However, it would also raise the post-tax income individuals receive from their current level of activity, so diminishing their incentive to work, save, and invest. The initial impact generally leads to a rise in economic activity, known as substitution effects, whereas the subsequent impact usually results in a fall in economic

activity, referred to as income effects. Furthermore, if spending cutbacks do not cover them, tax cuts will result in an increase in government borrowing, so imposing additional constraints on long-term economic growth. The historical evidence and simulation assessments support the idea that tax cuts, when not accompanied by immediate spending reduction, will have a negligible impact on economic growth. On the other hand, reducing tax rates by immediately cutting unproductive spending will lead to an increase in output.

1.1 Decreases in income tax rates

Changes in income tax rates affect the actions of individuals and businesses through the effects on their income and the choices they make in response. Reducing tax rates enhances the post-tax advantage for those engaged in employment, saving, and investing, so positively impacting the overall size of the economy. Due to the substitution effects, the larger after-tax incentives lead to a rise in labor effort, savings, and investment. This is the expected outcome of tax reduction on the size of the economy. Another beneficial outcome of pure rate cuts is the reduction in the impact of current tax distortions and the promotion of a more efficient allocation of economic activity. This shift occurs even if the overall level of economic activity remains the same, and it involves a move away from sectors that currently receive tax advantages, such as health and housing. Nevertheless, pure rate decreases can also yield favorable income (or wealth) outcomes by diminishing the necessity for labor, savings, and investments.

One example of how these advantages is integrated is the implementation of lower income tax rates for all individuals. The substitution impact raises the marginal return to employment and increases the labor supply. It reduces the worth of current tax incentives, hence changing the makeup of economic activity. Furthermore, it enhances a household's post-tax earnings across all levels of work effort, hence decreasing labor supply due to the influence on income. The impact on labor supply is yet uncertain. Decreasing tax rates have similar impacts on both savings and other activities.

The initial tax rate will impact the efficacy of a certain tax reduction. For example, if the initial tax rate on earnings is 90 percent, a reduction of 10 percentage points in taxes will result in the after-tax wage increasing from 10 percent to 20 percent of the pre-tax wage. However, if the initial tax rate is 20%, a reduction of 10 percentage points in taxes will only result in an increase of one-eighth in the after-tax salary, from 80% to 90% of the pre-tax wage. While the impact on income is consistent in all situations, the influence of higher tax rates on labor supply and savings is more pronounced. Consequently, the reduction in taxes would result in a larger increase in labor supply (or a smaller decrease in absolute terms) when tax rates are high. Furthermore, when the tax rate increases, the economic cost of the tax also increases exponentially. Therefore, the benefits of reducing tax rates are more significant when the tax rates are already at a high level.

1.2 Tax reform

Tax reform involves lowering income tax rates and expanding the tax base by reducing the use of tax expenditures and other items that limit the base.

By eliminating the special treatment given to specific categories of income or consumption, expanding the tax base has the tendency to raise the average effective marginal tax rates on labor supply, savings, and investment. There are two effects to consider: firstly, a revenue-neutral tax reform will have a smaller average substitution effect compared to a tax rate cut. This is because a lower tax rate increases the motivation to work, while broadening the tax base reduces this motivation. Secondly, a truly revenue-neutral reform should have an average income effect of zero.

Expanding the foundation has an additional impact that should help to the advancement of the economy. More specifically, it would reduce the amount of resources allocated to sectors and industries that already benefit from advantageous tax treatment. An equitable tax system that applies a uniform rate and encompasses a wider range of economic activities would incentivize the flow of capital from sectors that receive preferential tax treatment to other sectors of the economy that offer higher returns before taxes. The reallocation would lead to an expansion of the economy. Tax hikes not only affect private actors, but also have an impact on the economy through alterations in federal budgets. If the change is revenue-neutral, there would be no impact on funding as the reformed system would earn the same amount of income as the current system.

However, it is important to note that any reduction in taxes will ultimately need to be funded through a combination of future reductions in government spending, future increases in taxes, and borrowing to cover the difference between

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spending and revenue. Although the initial tax cut legislation may not have explicitly outlined the required policy changes, they must be present in some manner for the government to meet its budgetary constraints. Due to the inability to sustain financially unsustainable policies indefinitely, it is necessary to consider the funding of a tax cut while assessing its impact.

1.3 Other governmental entities

Federal tax cutbacks can prompt reactions not only from the central bank, state governments, and foreign governments, but also from other governmental organizations. The Joint Committee on Taxation (2014) examines the impact of various Federal Reserve Board policies on the economic development effects of Representative Camp's tax reform plans.

Oftentimes, the possible reactions of foreign governments are ignored. Decreases in U.S. tax rates that promote the flow of capital from foreign countries, for example, could motivate other nations to lower their own taxes in order to keep capital or attract funds from the United States. If other nations respond, the overall impact of reducing income taxes on economic growth will be diminished compared to the potential impact without such responses.

II. DISCUSSION

Both fluctuations in revenue volume and modifications to the tax system can influence economic activity, although not all tax modifications have comparable or even beneficial impacts on long-term growth. The concept that reductions in income tax might encourage economic growth has been expressed so often that it is occasionally considered an unquestionable truth. Nevertheless, theoretical frameworks, empirical data, and simulation studies provide an alternative and intricate account. Tax cuts can stimulate economic growth by boosting the motivation to work, save, and invest. However, they can provide income effects that reduce the necessity to participate in productive economic endeavors, and they may subsidize current capital, so offering unexpected profits to asset owners that diminish the motivation for new undertakings. Furthermore, implementing tax cuts as an independent policy, without corresponding cutbacks in government spending, frequently leads to an increase in the federal budget deficit. The rise in the national deficit will reduce national savings, as well as the capital stock possessed by Americans and future national revenue, while also raising interest rates, so adversely affecting investment. Therefore, the overall impact of the tax reduction on economic development is theoretically uncertain and relies on factors such as the nature of the tax cut and the timing and arrangement of its financing.

Multiple empirical studies have attempted to measure the aforementioned effects using different methods and models, but have consistently arrived at the same outcome. Over time, it is anticipated that long-term tax cuts, supported by increased deficits, will decrease rather than increase the national income. Simulation models indicate that implementing budget cuts alongside decreases in income tax rates can positively impact economic growth. Throughout the contemporary history of the United States, notable reductions in taxes (in 1964, 1981, and 2001/2003) were accompanied by augmentations in federal expenditure, rather than decreases. The concept that reductions in income tax might encourage economic growth has been expressed so frequently that it is occasionally considered an unquestionable truth. Nevertheless, theoretical frameworks, empirical evidence, and simulation studies give an alternative and intricately layered account.

III. CONCLUSION

The benefits of income tax reform, which involves revenue- and distributionally-neutral base-expanding, rate-reducing changes, are more intricate than the impacts of tax cuts, but they are built upon them. The effects of reducing interest rates are exactly the same as those mentioned earlier. The impact of reducing rates on budget deficits will be offset by expanding the tax base in a manner that maintains the same level of income. Additionally, it will reduce the impact of the rate decreases on effective marginal tax rates, and consequently, on labor supply, savings, investment, and other related factors.

Expanding the tax base will also have the effect of reducing the extent to which the tax code supports alternative sources and uses of income. This will reallocate resources to their most valuable economic use, thereby promoting economic growth and achieving a more efficient allocation of resources. In theory and in computer models, these

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outcomes can be significant, especially for drastic policy actions like eliminating all individual deductions and exemptions and implementing a uniform tax rate. Nevertheless, there is a scarcity of empirical studies on comprehensive income tax restructuring in the United States. This is mostly due to the fact that there has only been one significant tax reform in the past five decades. Expanding the tax base and lowering tax rates can enhance long-term performance, based on a sound theoretical premise and significant simulation data. The main objective is not to boost labor supply, savings, or investment, as it generates the same income from the same individuals as before. Instead, the goal is to achieve a more effective allocation of resources across different economic sectors by eliminating specific subsidies. Reforms that enhance incentives, eliminate current subsidies, reduce unexpected profits, and minimize borrowing to cover deficits will have greater positive impacts on the long-term scale of the economy. However, in some cases, these reforms may also result in trade-offs between fairness and effectiveness. These findings emphasize the potential advantages and drawbacks of income tax reform on the sustained expansion of the economy.

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